



# STRUCTURAL BALANCE AND THE 2007 BIENNIUM OUTLOOK

## GENERAL FUND

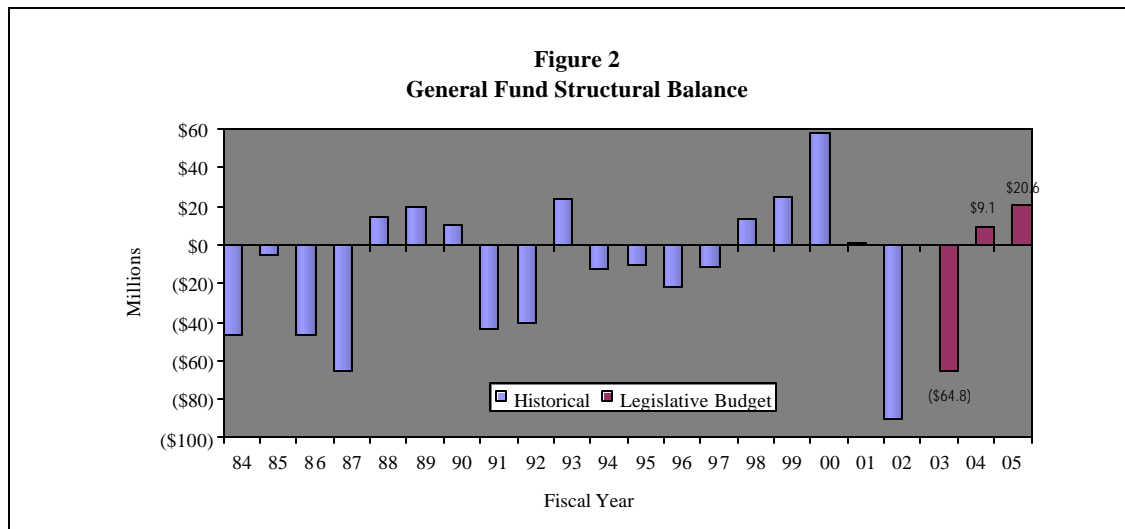
### STRUCTURAL BALANCE

Structural balance is defined as the matching of *ongoing* revenues with *ongoing* expenditures. If revenues equal or exceed expenditures, structural **balance** is achieved. Conversely, if expenditures exceed revenues, structural **imbalance** occurs. General fund expenditures have exceeded revenues for six of the last nine biennia in the 1980s and 1990s (see Figure 1). The structural imbalance for the 2003 biennium is expected to be \$155.0 million. In order to keep the account solvent, the legislature approved numerous one-time transfers, expenditure funding shifts, accounting modifications, and temporary revenue enhancements.

Figure 1 Revenue and Disbursement History General Fund & School Equalization Accounts In Millions										
Fiscal Year	General Fund		Surplus / Deficit	School Equalization		Surplus / Deficit	GF/SEA Revenue	GF/SEA Disburse.	Surplus / Deficit	Biennium Surplus/Deficit
	Revenue	Disburse.		Revenue	Disburse.					
A 84	\$330.305	\$357.387	(\$27.082)	\$242.384	\$261.753	(\$19.369)	\$572.689	\$619.140	(\$46.451)	
A 85	364.522	380.359	(15.837)	281.275	271.016	10.259	645.797	651.375	(5.578)	(\$52.029)
A 86	349.541	366.815	(17.274)	252.899	282.166	(29.267)	602.440	648.981	(46.541)	
A 87	346.690	391.325	(44.635)	263.052	283.428	(20.376)	609.742	674.753	(65.011)	(111.552)
A 88	391.152	370.853	20.299	276.216 *	281.886	(5.670)	667.368	652.739	14.629	
A 89	411.729	388.270	23.459	275.589 *	279.536	(3.947)	687.318	667.806	19.512	34.141
A 90	447.962	432.323	15.639	282.389	287.393	(5.004)	730.351	719.716	10.635	
A 91	420.257	457.612	(37.355)	385.031	391.500	(6.469)	805.288	849.112	(43.824)	(33.189)
A 92	487.036	523.072	(36.036)	393.591 *	398.059	(4.468)	880.627	921.131	(40.504)	
A 93	539.955	523.553	16.402	412.903	405.067	7.836	952.858	928.620	24.238	(16.265)
A 94	480.021	497.921	(17.900)	411.834	406.388	5.446	891.855	904.309	(12.454)	
A 95	646.149	535.461	110.688	289.199 *	409.822	(120.623)	935.348	945.283	(9.935)	(22.389)
A 96	963.193	984.997	(21.804)				963.193	984.997	(21.804)	
A 97	986.570	997.835	(11.265)				986.570	997.835	(11.265)	(33.069)
A 98	1,034.382	1,020.591	13.791				1,034.382	1,020.591	13.791	
A 99	1,068.111	1,043.418	24.693				1,068.111	1,043.418	24.693	38.484
A 00	1,163.641	1,105.598	58.043				1,163.641	1,105.598	58.043	
A 01	1,269.472	1,268.938	0.534				1,269.472	1,268.938	0.534	58.577
A 02	1,265.713	1,355.903	(90.190)				1,265.713	1,355.903	(90.190)	
F 03	<b>1,222.723</b>	<b>1,287.518</b>	<b>(64.795)</b>	Legislative Budget			<b>1,222.723</b>	<b>1,287.518</b>	<b>(64.795)</b>	<b>(154.985)</b>
F 04	<b>1,310.839</b>	<b>1,301.721</b>	<b>9.118</b>	Legislative Budget			<b>1,310.839</b>	<b>1,301.721</b>	<b>9.118</b>	
F 05	<b>1,335.056</b>	<b>1,314.477</b>	<b>20.579</b>	Legislative Budget			<b>1,335.056</b>	<b>1,314.477</b>	<b>20.579</b>	<b>29.697</b>

\* Excludes Education Trust & General Fund Transfers.

Note: The 1995 Legislature de-earmarked school equalization revenue to the general fund.



In the early 1990s, the legislature began to make progress toward addressing the problem of continuing structural imbalance in the general fund. In setting revenue and expenditure targets, the 1993 House adopted language prohibiting use of "one-time revenue...for any purpose other than creating an ending fund balance" and "temporary solutions to the state's chronic fiscal woes." This effort continued into future sessions, and final legislative actions taken during the 1993 and subsequent sessions have reflected these objectives. However, supplemental appropriations have sometimes contributed to a structural imbalance because the legislature does not budget for contingencies or other unforeseen events or emergencies.

On the expenditure side, legislators have faced the difficulty of restraining budget growth when confronted with double-digit growth in corrections costs, increased human services demands, and rising funding requirements for education. In the 1993 and subsequent sessions, the legislature enacted measures to contain costs in programs growing faster than revenues, such as Medicaid and foster care. These measures were designed to slow expenditure growth and to help the legislature reach structural balance in the general fund in future biennia.

The effort to minimize use of one-time revenues and enact measures to permanently control expenditure growth began to show success in recent biennia. However, the 2001 legislature adopted a \$56.9 million structurally unbalanced budget for the 2003 biennium. Two years later, expected revenues deteriorated significantly and the imbalance grew to nearly \$155.0 million for the 2003 biennium. This amount is in spite of over \$80 million in budget reductions implemented by the executive under 17-7-140, MCA, and legislative actions taken during the August 2002 Special Session. The only reason the ending fund balance for the 2003 biennium remains positive is because the biennium began with a \$172.9 million carry-forward balance.

The difficult task of achieving structural balance is further exacerbated by delayed implementation of expenditure increases and revenue reductions in future budget cycles (2005 biennium and beyond). In many cases, expenditure increases do not occur at the beginning of the biennium, but are phased-in over the biennium. This results in less cost for the current biennium, but increased costs to fund the same level of program services in the following biennium. As an example, the state employee pay plan

increases are phased-in over the 2005 biennium, and the cost to fully fund the pay plan in the 2007 biennium will result in a general fund increase of \$16.5 million.

Phased-in revenue reductions have the same effect as phased-in expenditure increases. For example, SB 407 authorized an increase in cigarette, tobacco, rental car, and lodging facility taxes coupled with a corresponding reduction in individual income taxes. Because of the phased-in provisions for the individual income tax reduction, the bill will increase general fund revenues by \$61.7 million in the 2005 biennium, but decrease general fund revenues by \$17.5 million in the 2007 biennium.

As shown in Figures 1 and 2, general fund revenues exceed expenditures for fiscal 2005 before adjusting for one-time revenues. Since most one-time revenue enhancements enacted by the 58<sup>th</sup> Legislature occur in fiscal 2003 and 2004, the general fund could be considered structurally balanced for fiscal 2005. In essence, the revenue and expenditure bases are approximately equal.

## OPTIONS FOR THE 59<sup>TH</sup> LEGISLATURE

Based on this supposition, and assuming that fiscal 2005 revenues equal the estimated amounts, the 59<sup>th</sup> Legislature will have different budget options depending on the level of revenue growth anticipated for the 2007 biennium.

- The legislature could appropriate additional funds (or enact tax reduction initiatives) equal to the anticipated revenue growth. This option may mean that some “present law” services may not be funded if the revenue growth is insufficient to cover all “present law” costs. The legislature would be faced with the task of prioritizing state services within the constraints of revenue growth. Since “present law” budgets are developed based on existing statutory requirements, only those services funded would be considered “present law” for future biennia provided the statutory obligations have been repealed.
- Another option would be to enhance state revenues via tax policy initiatives if the legislature wanted to fund “present law” services above anticipated revenue growth. For example, if the 2007 biennium revenue growth is expected to be 3.0 percent, then total general fund appropriations, including the effects of tax policy modifications, could not exceed 3.0 percent without a tax increase. If the costs of “present law” services exceed 3.0 percent, then revenues would have to be increased accordingly to fund services in excess of the anticipated revenue growth.
- The third option would be for the legislature to do a combination of the above options.

## MAJOR KNOWN REVENUE REDUCTIONS AND EXPENDITURE INCREASES

Figure 3 shows major estimated general fund revenue reductions and expenditure increases categorized by statutory and policy driven issues. It is a very preliminary analysis of the potential revenue and expenditure picture that the 2005 legislature may face. The information in the table is based on an analysis of specific statutory requirements and policy issues that the legislature must address in order to either reduce costs or enhance revenues. It is important to note that this analysis and Figure 1 do not include all components of a present law analysis, as such an estimate at this point in time would be premature. A complete present law forecast would likely result in a larger estimated expenditure growth. This analysis includes only the most significant present law statutory and policy issues. Other present law factors not included in this analysis are discussed on page 139 as "Other Factors".

Figure 3 Major Revenue Reductions & Expenditure Increases 2007 Biennium	
<u>Statutory Issues</u>	<u>Millions</u>
Individual Income Tax Reduction	\$17.5
Public School Support	14.9
Employee Pay Plan	16.5
Local Government Entitlements	9.2
Total Statutory	\$58.1
<u>Policy Driven Issues</u>	
Medicaid Service	38.2
Corrections	6.8
Total Policy	\$45.0
Estimated Total Impacts	\$103.1

Statutory issues are revenue and expenditure budget items that are defined by current statute or that will be effective July 1, 2003. These issues must be funded during the 2007 biennium unless statutory changes are adopted by the next legislature. Policy driven issues are expenditure issues that the legislature may have some discretion in modifying based on adopted policies. A brief explanation of each item follows.

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### ***Individual Income Tax Reduction***

Senate Bill 407 increases several taxes and reduces individual income taxes beginning in tax year 2005. Because of the phased-in aspects of the legislation, the full impact of the bill will not be realized until the 2009 biennium. The decline in individual income tax revenue combined with the selected tax increases, will reduce general fund revenue by \$17.5 million in the 2007 biennium.

### ***Public School Support***

The expected increase in spending on K-12 education in the 2007 biennium is \$14.9 million above appropriated spending in the 2005 biennium. This amount is based on the assumption that enrollment will decline by 1.5 percent per year in fiscal years 2006 and 2007. More than offsetting this decrease is the impact of the inflation adjustment to K-12 entitlements that was enacted in SB 424. It is expected that the inflation factors used for each year of the 2007 biennium will be 2.5 percent, the long-run average inflation rate over the last ten years, resulting in a \$13.4 million increase. In addition to the increase in entitlements, spending on special education will also increase by \$1.5 million in the 2007 biennium because the \$1.5 million increase in special education spending in the 2005 biennium occurs only in fiscal 2005.

### ***Employee Pay Plan***

The legislature funded an increase in monthly insurance contributions of an extra \$44 per month in calendar 2004 and an additional \$50 per month in calendar 2005. Because the full 2007 biennium cost (\$94 per month) is only reflected for six months in the 2005 biennium, 2007 biennium costs will be

about \$19.2 million general fund, an increase of \$11.0 million. The legislature also provided a \$0.25 per hour increase in the last six months of the 2005 biennium. Implementation for a full biennium will cost about \$7.4 million general fund, or \$5.5 million more than the 2005 biennium.

### ***Local Government Entitlements***

HB 124 (enacted by the 2001 legislature) statutorily appropriated general fund entitlements to counties, cities, consolidated governments and to Tax Increment Financing Districts will increase by \$9.2 million in the 2007 biennium compared with the 2005 biennium. The entitlement growth is the result of a statutory formula that depends on the average growth over the prior four years of Montana's gross state product and Montana personal income. The biennial increase of \$9.2 million assumes the average growth in the combined indexes will be 4.8 percent per year for each year of the 2007 biennium. This is slightly below the growth utilized to calculate the entitlement growth in the 2005 biennium. In addition, the biennial increase of \$9.2 million reflects the elimination of entitlements to industrial tax increment financing districts beginning fiscal 2006.

### ***Medicaid Service***

Medicaid service cost increases could add as much as \$38.2 million in general fund costs assuming an annual 5.0 percent increase due to changes in the number of eligible persons, utilization of services, changes in prescription drug costs, and minimal increases in sources of state special revenue used as Medicaid match (primarily tobacco settlement funds). This estimate also assumes that the state match rate would be around 27.5 percent.

However, the most significant policy decisions with respect to Medicaid services may not be the cost of the services. The Department of Public Health and Human Services (DPHHS) is undertaking a study during the 2005 biennium to "redesign" the Medicaid program. DPHHS staff testified that proposed changes due to the redesign would be presented for consideration and approval by the 2005 legislature. These changes could potentially have considerable impact for Montanans regarding:

- Health outcomes
- The cost of health care
- Types of health care services available

### ***Corrections***

The \$6.8 million increase in the Department of Corrections is based upon a 4.0 percent per year increase in populations, distributed roughly in the same percentage as anticipated population distributions in the 2005 biennium. This rate assumes continuance of population control measures. Control of populations and corresponding costs in the 2007 biennium will in large part be dependent upon the success of placement and treatment efforts, and on the willingness of the legislature and the public to accept consequences of other population reduction measures such as early release.

## **OTHER FACTORS**

The legislature will no doubt face a number of other fiscal challenges (not included in Figure 2) in the 2007 biennium that are either unknown or for which the legislature has a greater range of funding options, but for which pressures to increase expenditures could be significant. The two primary areas are:

- District courts - The state assumed the costs and operation of district courts in fiscal 2003. Because district courts have variable costs that are difficult to predict from year to year, future costs of the district courts are unknown.

- Higher education - Appropriations of general fund are strictly a legislative prerogative, but pressures to increase appropriations for both university initiatives and ongoing costs and to reduce tuition increases are a part of any appropriations discussion.

The legislature also replaced general fund with other funds in the 2005 biennium for which either the general fund will have to be replaced, or other programmatic adjustments made:

- In the Department of Justice, \$8.7 million in general fund for prisoner per diem and to partially fund the Motor Vehicle Division was replaced with highways state special revenue. In the 2007 biennium, either potential reductions in operations in the Department of Transportation or in one or both of the Department of Justice programs will be likely.
- The legislature utilized tobacco settlement funds allocated for tobacco prevention programs in 1-146 for other programs in the Department of Public Health and Human Services. Either tobacco revenues will continue to be diverted or other programmatic reductions made in the 2007 biennium.

Other present law growth not included in the above analysis is inflationary and other caseload/workload growth in the smaller state agencies.

## SUMMARY

The projected structural balance for fiscal 2005 is positive at \$20.6 million. Although the state could be considered structurally balanced at that time, there are fiscal “potholes” that could be troublesome as the state moves toward the next biennium. As shown in Figure 2, the 59<sup>th</sup> Legislature will be required to fund \$58.1 million of additional costs just to meet statutory obligations. To this, an additional \$45.0 million of selective policy driven costs may be need to be funded under “present law”. The total impact of \$103.1 million in additional costs would require about 3.9 percent growth in 2007 biennium revenues to provide the necessary funding. Not included in Figure 2 are other more discretionary “present law” costs such as those mentioned in the preceding section “Other Factors.” In addition, structural balance depends largely on the ability of ongoing revenue to meet projected growth rates. If revenues continue to be weak, or are slow to recover, the state may face a similar fiscal crisis in the 2005 biennium as faced in the 2003 biennium.

## HIGHWAYS STATE SPECIAL REVENUE ACCOUNT PROJECTIONS

Figure 4 summarizes the projections of working capital for the highways state special revenue account. This account funds the Department of Transportation highway planning, construction, and maintenance activities, highway safety enforcement activities in the Department of Justice, state park road maintenance functions in state parks, and capital projects related to highways infrastructure. The highways state special revenue account is chronically structurally imbalanced, and the level of revenue growth cannot sustain the level of expenditure growth needed to support the services provided. The projections show the account is anticipated to be expended at a higher level than expected revenues for the 2005 biennium (expenditures will exceed revenues by \$32.4 million), and the account is projected to go negative in fiscal 2005. A detailed working capital analysis for the highways state special revenue account is provided in the Department of Transportation agency discussion in Volume 3, page A-79.

Figure 4 Highways State Special Revenue Account Projected Working Capital Analysis Fiscal Years 2002 - 2009 (in Millions)								
	Fiscal 2002 Actual	Fiscal 2003 Approp.	Fiscal 2004 Approp.	Fiscal 2005 Approp.	Fiscal 2006 Estimate	Fiscal 2007 Estimate	Fiscal 2008 Estimate	Fiscal 2009 Estimate
Beginning Working Capital Balance	\$41.1	\$51.4	\$31.5	\$13.4	(\$0.9)	(\$11.6)	(\$20.8)	(\$28.3)
Revenues	214.0	215.0	214.3	210.8	214.7	216.3	217.9	219.6
Available Working Capital	255.1	266.4	245.8	224.2	213.8	204.7	197.2	191.3
Authorized Expenditures	205.2	234.9	232.4	225.1	225.4	225.4	225.4	225.4
Adjustments	1.5	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Ending Working Capital Balance	\$51.4	\$31.5	\$13.4	(\$0.9)	(\$11.6)	(\$20.8)	(\$28.3)	(\$34.1)

The account is chronically imbalanced in large part because of a relatively inelastic revenue base – motor vehicle fuel taxes. Construction, maintenance, and operating expenditures increase with general inflation whereas the tax on motor fuels is a fixed percentage per gallon. Tax revenues increase only if the number of gallons sold increases and not relative to the price of gasoline. As such, there is no link between expenditure inflation and revenues. In the long term, revenues cannot sustain the escalating costs of the highway program without impacts on the level of the highway program. If federal funds increase as anticipated when the federal highway funding legislation is reauthorized after September 2003, and if a full match of available federal funds is to be achieved to provide a fully funded highways program, a revenue increase may be needed.

